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AUTHOR(S):

KURASAWA, Motonari; NARIU, Tatsuhiko; TORII, Akio

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## **The Marketing Channels for Textiles and Apparel**

*by* Motonari KURASAWA,\* Tatsuhiko NARIU\*\* *and* Akio TORII\*\*\*

### **I Introduction**

Japan's distribution system faces various criticisms from western countries. One criticism is that the mediation of numerous distributors between the production and consumption stages raises the total margin in most distribution channels. Another criticism holds that Japanese traditional trade customs, bred in long-term relationships between producers and distributors, make the trading process ambiguous and complicated. Moreover, those customs are denounced as barriers to the entry of foreign producers in Japan.

When Japan's distribution system is criticized as inefficient because of its multi-step wholesale transactions between producers and consumers, the criticism itself may be based on a fundamental view which regards the transportation of products as the principle role of distributors. This view leads to the assumption that the longer and the more complicated the distribution systems, the less efficient they are. Nevertheless, the authors do not believe that distributors trade products in vain. If there are multiple wholesalers between producers and consumers, it is natural to think that they contribute different functions.

For smooth distribution, information should be shared. One method of benefitting from information sharing is to sell directly in market. However, because information is easily reproduced and because buyers of information cannot appreciate the contents prior to trade, this ap-

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\* Professor, International Graduate School of Social Science, Yokohama National University.

\* \* Professor, Graduate School of Economics, Kyoto University.

\* \* \* Professor, International Graduate School of Social Science, Yokohama National University.

proach can not necessarily be completed unless some special measures are taken. Another method of benefitting from the use of information is to participate directly in production or distribution. This results in long and complicated channels.

An investigation of the textile and apparel industry, which is the focus of this paper, reveals its long distribution channels, which involve both trading firms and wholesalers. Most producers are small and specialize in one of the succeeding processes such as dyeing, twisting, weaving, or finishing. While they have the know-how to carry out these specialized processes, they lack market information regarding trends in supply and demand. It is wasteful that each producer gathers individually this kind of market information. On the other hand, trading companies or wholesalers have a comparative advantage in analyzing market trends, but do not have the know-how concerning production processes. Wholesalers and traders organize the whole production and distribution processes to exploit their knowledge of market trends; they plan and design new products and bear sales risk, placing out the production to subcontractors and paying a fixed amount of commission. As a result, the flow of ownership describes a long channel, wholesalers intervening between each production process.

In apparel distribution we observe many obsolete trade customs such as the liberal acceptance of returns of unsold merchandise. Commodities in this industry have wide diversity and the sales are influenced by fashions. Therefore, the demand for each commodity is uncertain and the sales fluctuate unpredictably. When purchasing this kind of product, consumers search several retailers to compare possible items. As a consequence, displayed items and shopkeepers' recommendations play important roles in affecting consumers' choices.

In apparel as in other industries, manufacturers who are also wholesalers take the initiative in product planning. Most of the products manufactured by apparel makers/wholesalers are sold directly to retailers. This makes it easy for manufacturers to induce the cooperation (recommendations) of retailers. Retailers have records of the past consumption trends in their marketing areas. Most of them, however, are too small to be able to predict future demand trends. Therefore, under non-consignment contracts, the number of items ordered by retailers is less than that needed to sufficiently display products; ordering a safe number of items is a tactic used by retailers who wish to avoid a backlog of unsold merchandise. Given these circumstances, one method used to induce larger orders from retailers is to alleviate their marketing risks. The policy under which unsold products can be returned to wholesale manufacturers can be understood as an instrument which makes possible the transfer of marketing risks and assures that an optimal amount of goods are displayed in retailers' store fronts.

This paper investigates the marketing channels for textiles and apparel, with particular reference to the economics of information. The sections are organized as follows: Section 2 overviews the textiles and apparel industry, where we focus on the long multi-stepped wholesale system in the middle courses of textiles distribution, and the direct channels in apparel distribution. In Section 3, the information transfer function of distribution systems are outlined. We shall explain why information about demand trends is not traded in the market. Rather, the holders of information directly manage marketing channels. From this standpoint the textile industry's multi-stepped channel is analyzed in Section 4. In Section 5, we explore into the apparel distribution system, focusing upon the economic function of a liberal returns policy. Section 6 contains our conclusions.

## II Fact-finding in the Textiles and Apparel Industry

In this section, we outline the salient characteristics of marketing channels in the textiles and apparel industry.

### II-1 Outline of the Textiles and Apparel Industry

From the post-war reconstruction period to the high-growth period, the textile industry in Japan has made enormous contributions to the national economy. The sluggish domestic demand during the oil crisis of 1974 plunged the industry into a temporary slump. Its recovery was aided by management rationalizations and government subsidies. However, because of imports from Asian countries, the rapid appreciation of yen after 1985, and the sluggish domestic demand caused by the eruption of speculative *bubbles*, the silk-reeling, yarn, and fabrics industries are in very severe circumstances. The textile industry's share of the overall shipments of manufacturing industries is decreasing steadily: from 19 percent in 1955, 12 percent in 1965, 5 percent in 1985, to 4.3 percent in 1990. Also the number of those employed in the industry has declined rapidly: while the yarn industry had 50,000 employees and fabrics industry 140,000 in 1990, a little more than 30,000 and 100,000 respectively still made their living in these professions in 1994.<sup>1)</sup>

Table 1: Connected Indexes of Productions in Textile Industries

Year	Textile	Chemical Fibers	Silk Reeling	Yarn	Fabrics	Dyeing Finishing	Secondary Products
1950	12.8	1.9	177.5	28.4	25.3	—	—
1955	30.5	6.1	296.9	65.3	56.1	36.2	23.9
1960	49.3	14.7	308.4	98.1	87.7	57.0	34.9
1965	71.4	34.3	326.6	118.2	98.5	77.4	67.1
1970	108.3	78.6	364.2	146.5	125.3	100.2	98.8
1973	122.0	95.8	344.2	160.7	136.9	105.0	115.0
1975	102.9	76.7	359.5	121.8	113.3	97.4	99.0
1980	111.6	99.6	289.6	130.0	122.6	99.6	106.4
1985	108.9	99.8	168.1	122.9	112.4	106.9	107.4
<b>1990</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
1994	81.9	95.3	68.2	68.4	76.9	84.4	84.4

Data: Nihon Sen'i Shinbun (1994)

According to 1990 statistics the textile manufacturing industry consists of about 130,000 enterprises which combine to ship 14 trillion yen worth of goods by 1,270,000 workers. Its shares among all manufacturing industries are 10.8 percent in employment and 4.3 percent in shipment, which show the labor-intense nature of this industry. The exports and imports are 7.2 billion and 12.8 billion yen respectively (when raw materials are included the import level rises to 15.4 billion yen). Note that imports are larger than exports. The industry's share of the total exports and imports in Japan are 2.5 percent and 5.5 percent (6.6 percent) respectively.<sup>2)</sup>

- 1) Nihon Sen'i Shinbun (1994, p.65) and MITI(1994, p.195). In synthetic fiber the production show no substantial decline owing to innovation of new products.
- 2) The Nihon Sen'i Shinbun-sha(1994, p.65).

Table 2: The Shares in the Whole Manufacturing Industries

Year	Numbers of Establishments	Numbers of Workers (thousand)	Shipments (billion yen)	Value Added (billion yen)	Exports (million dollar)	Imports (million dollar)
1985	142,167 19.0	1,334 11.6	13,340 5.0	5,333 5.8	6,263 3.6	6,041 4.7
1990	130,063 17.8	1,271 10.6	13,952 4.2	6,080 4.7	7,195 2.5	15,448 6.8

Data: Nihon Sen'i Shinbun (1994)

As shown in Figure 1, the manufacturing processes and distribution channels are very complicated. By the 1989 Census of Manufacturers the average number of workers per enterprise was less than 10 persons; enterprises with three or fewer workers occupy more than half of the total enterprises (4 percent of the total shipments); those with twenty and more workers account for 10 percent (about two thirds of the total), and those with no less than 300 workers only 0.1 percent (a little more than 10 percent). Thus, as shown, most of enterprises are small

Materials 237/30,807 <b>1,270/11,196</b>	Chemical and Synthetic Fibers 93/26,195	Fiber Material Wholesaler <b>1952/9,811</b>	Silk and Cocoon Wholesaler <b>318/1,385</b>
		Yarn Mill 807/61,223	Silk Reeling 144/4,648
		Throwing and Thread Mill 7,826/32,797	
Yarn 8,633/94,020 <b>1,043/ 8,713</b>		Yarn Trading House <b>1,043/8,713</b>	
	Lace Knit 3,244 17,605	Fabrics 32,836 148,262	Knit 17,545 195,773
			Net 1,206 12,843
			Miscellaneous 8,654 64,960
Fabrics 71,410/543,275 <b>9,742/ 96,187</b>		Fabric Wholesaler <b>9,742/96,187</b>	Dyeing and Finishing 7,925/103,832
	Apparel and Textile good Manufacturing 50,417/615,268	Underwear and Bedclothes Manufacturing <b>25,306/326,438</b>	Curtains and Other Housefurnishings Manufacturing <b>2,292/22,075</b>
Textile Secondary Goods 50,417/ 615,268 <b>227,415/1,465,608</b>	Department Store <b>1,911</b> <b>393,686</b>	Textile and Apparel Retailer <b>175,231</b> <b>616,015</b>	Furniture Retailer <b>22,675</b> <b>107,394</b>

Figure 1: A Overall Picture of Manufacturing Processes and Distribution Channels in the Textile Industry

Notes: Bold face type indicates Distributors. Numbers below each column indicate number of store for the former and number of workers for the later respectively. The total numbers are 232,470 stores and 1,581,704 workers. The columns of manufacturing sectors are followed by number of establishments and of workers, whose totals are 130,679 and 1,283,370 respectively. Date: Survey of Manufacturers(1989) and Survey of Commerce(1988).

and medium-sized, which is a prominent characteristic among fabric manufacturers (the average number of workers per enterprise is 4.5 person).<sup>3)</sup>

Japan's yarn industry annually yields 1.84 million ton overall, 0.59 million ton of natural fibers, 1.25 million ton of man-made fiber, including 1.06 million ton of synthetic fiber. Exports and imports were 0.15 million ton and 0.3 million ton respectively. About 2 million ton are used for the production of various commodities as intermediate inputs: 0.98 million ton for synthetic fibers (49 percent), 0.63 million ton for natural fibers (31 percent), and 0.40 million ton for miscellaneous fibers (20 percent). As for the usages, the industrial use of 0.77 million ton, such as tire code, occupies the largest part at 40 percent. Other usages include 0.62 million ton for apparel (30 percent), 0.39 million ton for housefurnishings such as bedclothes, and 0.23 million ton for household interiors, such as rugs and curtains (10 percent).<sup>4)</sup>

Wholesalers and retailers participate in various aspects in the distribution of the intermediate and final products. *The 1988 Census of Commerce*, showed the number of stores wholesaling textiles to be 12,000 including wholesalers of textile fabrics, the number of workers to be 116,000, and the total sales at a level of 14 trillion yen. Corresponding statistics for apparel and apparel accessories, revealed that there were 25,000 stores, 326,000 workers, and 17 trillion yen worth of shipments. The total wholesale sales amount to 31 trillion yen. There are 175,000 retail shops, including those of apparel and personal belongings, which employ 611,000 workers, and annually achieve 11 trillion yen in sales. Adding to this figure the sales of department stores of 5.5 trillion yen and mail-orders, the total retail sales per year are estimated at about 17 trillion yen.

## II-2 Production and Distribution of Fabrics

There are many kinds of textile goods, each having a unique marketing channel. For example, the distribution channel for men's suits is shown in Figure 2. For most textile goods, as shown in this example, trading houses or wholesalers intervene at every node along the distribution channel, from when thread is purchased to make the fabric, to the exchange of the woven fabrics, all the way to when the apparels are finished.

There are several processes involved in the production of woven fabrics such as preparing, weaving, and finishing, and each process can be divided into several sub-processes. Producers gather in specific geographical areas (*sanchi*). Some have integrated mills, but most are specialized in particular processes. Generally, these manufacturers are small: they perform specified operations, but they do not gather information about market trends. Therefore, they cannot plan and sell new products by themselves.

In the making of woolen fabrics, yarns are traded from yarn mills to parent weaving houses (*oya-bata*) directly or indirectly through yarn trading houses as is shown in Figure 2. The *oya-bata*, as a production organizer, plans a new product and weave a sample swatch (*masu-mihon*), which they used to contract quantities, unit price, and delivery dates with trading houses or woven wool wholesalers.<sup>5)</sup> After taking orders from trading houses and woolen fabric whole-

3) The Nihon Sen'i Shinbun-sha (1994, p.66).

4) Hirai (1994, pp.74-7). Used data are based on reports from MITI and Nihon-Kagaku-Sen'i-Kyokai.

5) Kokumin Kinyu Kouko Chosabu (1990, p.243-4).

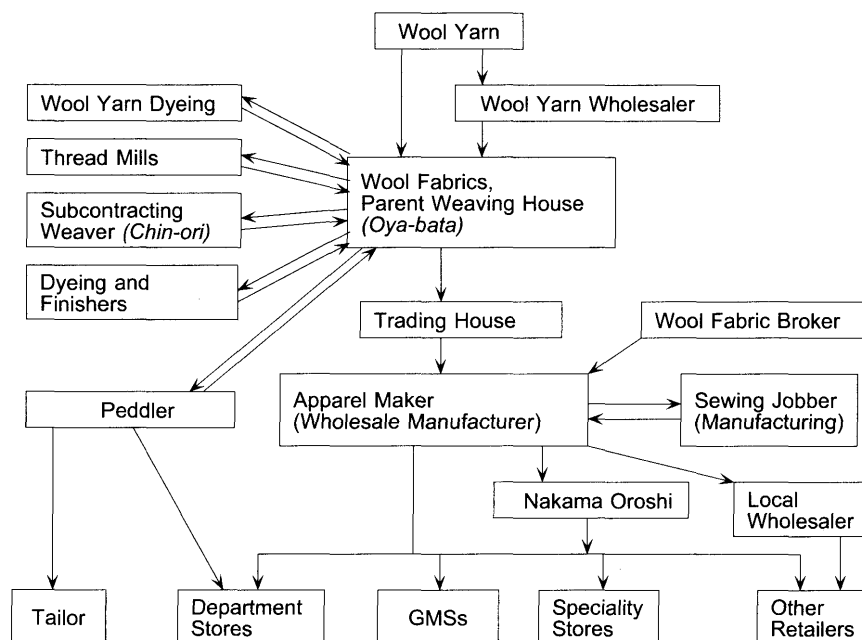


Figure 2: The Distribution Channel of Men's Suits (wool)

Date: Kokumin Kinyu Koko Chosabu (1990)

salers, *oya-bata* mills assign some processes to contract or commission mills. These subcontracting mills are called *chin-ori*, and it is there that dyeing, throwing, twisting, texturizing, and finishing processes are performed. This arrangement is characteristic of the fabric industry in Japan: each fabrication process is subdivided into different special enterprises, most of which are subcontracted as *chin-ori*. For example, subcontracting weavers (*chin-bata*) process threads owned by *oya-bata*, and return the woven products to take commission. Other special enterprises are conducted similarly.

Table 3 shows the ratio of *chin-ori* subcontracting within the textile industries. The table

Table 3: Ratios of Chin-ori Sub-contracting Works

Industries	Year				Production
	1970	1980	1989	1994	
Cotton Fabric	44	45	50	48	1,180
Wool Fabric	63	76	74	73	286
Silk and Silk Fabric	24	18	25	25	65
Rayon Fabric	54	59	61	51	271
Synthetic Fiber Fabric	61	65	67	64	2,143
Artificial Silk Fabric	75	73	63		
Flax and Hempen Fabric	40	25	48		
Fabric Not Elsewhere Classified	46	70	81	74	173
Total	54	58	61	59	4,117

Data: Sen'i Tokei Nenkan

Table 4: Shares of Prime Contractors Who Depend on *Chin-ori*

Industries	Yarn Mill and Synthetic Fiber Yarn			Trading House and District Wholesalers			Oya-bata Parent Weaving House		
Year	'70	89	94	'70	89	94	'70	89	94
Cotton Fabric	23,	19,	19	63,	73,	70	14,	7,	10
Wool Fabric	15,	14,	12	10,	5,	57	4,	80,	77
Silk and Silk Fabric	3,	10,	3	64,	53,	48	29,	37,	5
Rayon Fabric	10,	2,	4	68,	88,	75	22,	9,	20
Synthetic Fiber Fabric	26,	21,	27	60,	70,	64	13,	7,	6
Artificial Silk Fabric	15,	20,		75,	62,	—	8,	18,	
Flax and Hempen Fabric	45,	4,		37,	58,	—	15,	37,	
Fabric Not Elsewhere Classified	25,	28,	36	66,	67,	52	9,	5,	9
Total	22,	18,	23	60,	67,	60	17,	13,	14

Data: Sen'i Tokei Nenkan

exhibits that the synthetic, as well as woolen, fabric industry has high ratios of *chin-ori*. Table 4 shows that a higher ratio of subcontracting works originated from the *oya-bata* in the woolen fabric enterprises, which reveals the *oya-bata's* predominate role in the industry.

There are a few differences in prime-contractors and the ratios of *chin-ori*, depending on the sort of textiles and the *san-chi* region. In Banshu (an area around Nishiwaki-shi, Hyogo Prefecture), enterprises specializing in cotton textiles produce 400 million m<sup>2</sup> fabrics each year, achieving 100 billion yen worth in shipments; Banshu's share in the overall amount of short predyed fibers is about 80 percent in Japan. Nihon-Kagaku-Sen'i-Kyokai (1989) reports that there are about one thousand preparers, about thirteen hundred weavers, eighteen dyers, and ten finishers in Banshu. All of them are organized by about eighty district trading houses. The number of weaving houses decreased from 1356 in 1985 to 1220 in 1988, and the age structure of employees is advanced. Weaving houses are very small: the mean of number of looms per house is sixteen, and the mean of number of employees is four. So, more than nine tenths of the weaving houses are engaged in *chin-ori* subcontracting which is delegated by district trading houses. Processing operations are based on *sashizu-sho* instruction documents assigned by trading houses, which details all processing steps, from the receiving of threads to the delivery of products. Based on these *sashizu-sho*, intermediate products flow from threads wholesalers, to dyers, preparators, weavers, finishers, inspectors, on to delivery. For example, weavers receive threads from preparers and deliver their woven fabrics to dyer/finishers, but commissions are paid directly from trading houses to subcontractors.<sup>6)</sup>

In the synthetic fiber side of the textile industry, a situation similar to that of woolen fabrics can be seen: as there is also a high ratio of *chin-ori*, especially in the Hokuriku district. Most weaving houses are not engaged in planning new products by themselves, but contribute only to the weaving operation. Also, similar is the fact that the organizers who plan commodities and

6) Kokumin-Kinyu-Koko (1990, p.55) In another district specializing in cotton textiles, Sensyu (the southern area of Osaka prefecture), a different aspect can be seen: the ratio of *chin-ori* subcontracting is low and we observe the buying of threads or selling of fabrics. As for *chin-ori*, they are assigned not by districts trading houses but by large trading houses or yarn mills in Osaka.



take risks are wholesalers, including trading houses or yarn mills' wholesale divisions.<sup>7)</sup> Thus, typically in most textile industries, planning and distribution are undertaken by trading houses, *oya-bata* weaving houses, and yarn mills, who organize and co-ordinate the whole system and provide financial functions such as giving loans or extending credit.<sup>8)</sup> Multi-step distribution channels of textiles have this type of production structure.

Figure 2 also shows that part of the finished fabrics are sold directly to apparel makers or cloth retailers instead of through channels from *oya-bata* to trading houses and fabric wholesalers on to apparel manufacturers, retailers, and department stores, and so on. In some channels wool fabric dealers mediate between *oya-bata* and apparel makers, while in others up-stream wool yarn mills organize both of them as *keiretsu*. Thus the involvement of woolen fabric dealers connecting numerous *oya-bata* and down-stream apparel makers causes distribution channels to be very complicated.

### II-3 Short Distribution Channels in the Apparel Industry

Apparel makers who buy fabrics produce what they plan and design, partly at their own factories and partly by assigning manufacturing processes to subcontractors such as sewing jobbers. Most of their products are sold directly to department stores, general merchandizing stores (GMSs), and other retailers. A part of them are also sold to brokers, although the shares only amount to 7-9 percent for men's suits and, 4-5 percent for knit articles. Thus, multi-stage wholesaling channels are not a part of apparel distribution.

The ratio of sales by *Jika-oroshi* (wholesalers who sell immediately to retailers) to sales by *moto-oroshi* (wholesalers who sell to other wholesalers) show obvious differences between the structure distribution channels in the fabrics and the apparels industries, as is shown in

Table 5: Ratios of Sales by *Jika-oroshi* (wholesaler who sell directly to retailers) to Sales by *Moto-oroshi* (wholesaler who sell to other wholesalers)

	1970	1979	1985
Textiles	0.24	0.36	1.19
Silk and Cocoon	0.16	0.22	0.22
Fiber Material	0.07	0.53	2.64
Yarn	0.60	1.21	1.80
Fabrics	0.30	0.29	0.91
Apparels and Apparel Accessories	2.26	2.28	2.28
Men's Clothing	4.14	4.10	2.13
Women's and Children's Clothing	2.21	2.37	3.20
Underwear	3.23	3.12	2.04
Bedclothes	1.30	1.23	1.23
Miscellaneous	1.36	1.32	1.48

Data: Survey of Commerce

- 7) Often district trading houses are organized in *keiretsu* by yarn mills (Kokumin-Kinyu-Koko, 1990, p115-6). Besides, in the production of synthetic fibers, middle-sized dyers or finishers have recently gained power through the use of new technologies.
- 8) Often obsolete trade customs are observed between them: contracts are not always accompanied with written documents, and runs of draft are prolonged. See Nihon-Sen'i-Shinbun-Sha (1990, p.65-6).

Table 6: Shares of Wholesalers who Supply Retailers and the Estimated Length of Wholesale Channels

Wholesale Segments	Primary Wholesaler <i>Ichiji-Oroshi</i> a	Secondary Wholesaler <i>Niji-Oroshi</i> b	Other Wholesaler	a/b	Number of Wholesale Steps	
					U.S.	Japan
Textiles					1.92	1.60
Men's Suits	0.418	0.271	0.311	1.54(1.59)	1.12	1.22
Women's and Children's Suits	0.514	0.272	0.214	1.89(1.10)	1.17	1.31
Underwear	0.601	0.179	0.221	3.36(4.48)		
Bedclothes	0.379	0.450	0.171	0.84(0.67)		
Bags and Bagging	0.719	0.145	0.136	4.95(6.87)		
House Furnishing Textiles	0.420	0.383	0.197	1.10( - )	1.11	1.48
Papers and Paper Products	0.502	0.339	0.159	1.74(1.52)	1.20	1.47
Medical Preparations	0.351	0.161	0.488	2.18(3.80)	1.04	1.16
Cosmetics	0.586	0.162	0.253	3.62(2.17)	1.19	1.34
Bread and Confectionery	0.500	0.238	0.262	2.10(2.05)	1.51	1.45
Teas	0.208	0.390	0.403	0.53(0.70)	1.35	1.67
Canned and bottled Foods	0.285	0.583	0.132	0.49(0.53)	1.18	1.76
Furniture and Fixture	0.522	0.148	0.330	3.53(3.03)	1.61	1.29
Pottery and Glass Products	0.42	0.367	0.206	1.16( - )	1.04	1.41
Hardware	0.545	0.314	0.141	1.74( - )	1.21	1.16

Data: Survey of Commerce

Table 5. The figures indicate that wholesale channels in apparel and apparel accessories are relatively long compared to those in fabric goods. Table 6 shows what type of wholesaler supplies retailers for several categories of goods. From the table one can grasp that the less the ratio of a/b (column 4), the longer the channel tend to be.<sup>9)</sup> The table shows that the wholesale segments with the longest channels (meaning that there are fewer primary wholesalers who purchase directly from manufacturers) are for canned and bottled goods or finished tea. The distribution channels of apparels, such as men's, women's and children's clothing, and underwear have a higher share of primary wholesalers. Especially in the distribution of underwear and drugs and cosmetics, the share of secondary wholesalers (those who purchase from other wholesalers) is relatively low.<sup>10)</sup> Compared to estimations for 1970, channels no longer have a tendency to become shorter. Note, however, the trend in women's and children's clothing channels in which the ratio of primary wholesalers to retailers has increased.

9) In wholesale segments where wholesalers not elsewhere categorized (such as wholesale branches of manufacturer) occupy larger share, a larger part of wholesalers are likely to belong to keiretsu.

10) This point can be recognized also from estimations of length of wholesale channels in Nariu and Flath (1993), which claims relatively shorter channels in men's clothing (1.22) and women's and children's clothing (1.31) compared to textile goods (1.60). See Nariu and Flath (1993) for the method to estimate and data. In the United States also the same tendency can be observed: lengths of wholesale channels for commodities show relatively smaller value in men's clothing (1.12) and women's and children's clothing (1.17) compared to textile goods (1.92).

### Return policy

As is seen above, long, multi-step wholesale channels do not characterize the distribution structure in the apparel industry. Rather, most goods are provided directly from apparel makers to retailers. However, a lot of goods remain unsold and are sent to other retailers. For example, goods not sold in the department stores in downtown Tokyo are sent to suburban department stores which belong to the same *keiretsu*; if they still remain unsold after this, they are finally sent to local department stores or retailers. A considerable portion of these remaining items are returned to wholesalers. When goods passed among many retailers they are sometimes handled by wholesalers. In this aspects, one can say that even in apparel distribution multi-step wholesale channels exist.

Although apparel wholesalers and makers are considered to be among those who accept a significant amount of returned goods (together with those of cosmetics and books), no evidence supports this assumption. In a report by Sen'i Torihiki Kindai-ka Suishin Kyogikai (1988), purchased goods account for 76.4 of all manufactured goods, compared to 18.3 percent for consigned goods and 5.3 percent for contracts with returns, (such as *uriage-shiire*, which is a trade custom under which the ownership of a good is transferred from a wholesaler to a retailer when the good is finally sold to a customer). However, when statistics are restricted only to the trades of department stores, the ratio of bought goods becomes substantially low. The distribution of purchased, consigned and return goods has not revealed a clear pattern over time, although the share of sales through department stores decreased through the 1980s.<sup>11)</sup> Thus before the late '80s, when the bubble burst, a considerable amount of unsold goods were returned, especially from department stores.

### II-4 Recent Trends

In Japan, the number of automobiles purchased for personal use increased rapidly in the 1980's from 24.6 million cars in 1981 to 34.9 million cars in 1990.<sup>12)</sup> This increase in car ownership is reflected in the extensions of suburban super stores which are not located close to public transportation stations. Likewise in apparel retailing, especially in men's suits, the number of large-scale stores has grown. In 1988, Aoyama, a major discount store chain carrying men's suits, sold 49.3 billion yen of merchandise through 127 shops; in 1993 sales had skyrocketed to 116.7 billion yen through 441 shops, a growth rate of about 20 percent annually.<sup>13)</sup> These discount stores' strategy is to promote lower prices with the slogan "Men's suits are not fashionable apparel, but a uniform for white-collar workers." When considered as a type of "uniform" (convenience good), men's suits are not affected severely by fashion trends and, therefore, will probably not end up as unsold items; since discounters don't feel that they're taking on a big risk in purchasing suits, they order in large quantities, which allows them to save on the purchase cost. Backed by this significant marketing power, discounters have influence up-stream in the manufacturing process. In fact, some become involved in these up-stream activities: assigning processing jobs of their own fabrics to apparel makers, or engaging in joint-development of new synthetic fibers

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11) Although in buying-in contracts, some part are returned.

12) United Nations, *World Almanac* (1990/91, table 101).

13) Senken Shinbun (August 9th, 1993).

with yarn manufacturers, (such as Toray or Teijin).

To compete with these discount stores, general merchandising stores employed a similar discounting strategy, for which the conditions were set by the hardening yen after 1985 which, in turn, encouraged imports from Asian countries. Import statistics reveal that 1.81 million suits were imported in 1991; this figure doubled to 3.8 million suits in 1993.<sup>14)</sup> Two thirds of these imports come from Mainland China, followed by South Korea and North Korea. With large scale buy-ins, general merchandising chains save not only on purchase costs, but also on marketing costs, because the assortment of items is limited. Through this strategy, general merchandising chains have achieved discount prices.

On the other hand, department stores direct their energies in the development of private brand men's suits priced at around fifty thousand yen. Before, they only provided goods developed by apparel makers with a condition of returns. But now, they endeavor to lower their purchasing cost by planning and designing new products by themselves, consigning processing, and buying in large scale. For women's apparel they try the same approach, but short-lived fashion trends leave department stores significant amount of unsolds. Previously, unsold goods were returned under a consignment contract, but with a buying-in contract, they have to dispose of them by themselves. Therefore, some department stores have begun to open outlets which mainly offer goods that did not sell the first time around.

### **III Roles of Information in Distribution Channels**

The role of distribution is to bridge various gaps in space, time, ownership, and information between production and consumption. In most cases, the place of production (factory) is located away from the place of consumption (household). The space discrepancy is bridged by transportation. In the same manner, consumers can order what they want and have it supplied at the time they need it, a measure which bridges time gaps. That trades involve the transfer of ownership of goods from manufacturers to consumers does not need to be said. In addition to these transportation and commerce functions, the transfer of information between production and consumption is necessary for the smooth operation of successive processes: planning, designing, manufacturing, and marketing. This section overviews the transfer of information within distribution channels.

#### **III-1 Information and Transaction**

Manufacturers do not have enough information about what consumers need. Also consumers do not have perfect information about trading conditions, such as what kind of products are traded, their qualities and prices, and where they can be purchased. One of the primary functions of a distributor is to bridge information gaps between production and consumption: giving information about demand trends of consumers to manufacturers, and giving consumers information about what kind of products are traded under what conditions.

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14) Nikkei Sangyo Shinbun (August 26th, 1993).

### Information necessary for efficient distribution

The first step required in the smooth operation of a distribution system involves planning and producing products which are based on the knowledge of consumers' demands. Information about consumers' behavior includes not only raw information, such as past sales record or market research reports, but also secondary information which results from analysis. Second, in order to plan and design a product with a competitive edge, and to acquire profits from its sales information about suppliers is required. Information such as what kind of related products are produced by rival companies and under what conditions they are sold must be analyzed. Technical expertises, including knowledge of manufacturing processes are also required to organize an efficient production system.

Furthermore, marketing products requires transmitting information concerning the existence of products, their prices and qualities, and where to buy them. At the same time, sales promotion activities are important to stimulate consumer's eagerness to buy. Such activities require further expertise such as arranging appropriate displays in light of the consumers' preferences and buying behavior.

The information, knowledge, and know-how necessary to construct an efficient marketing channel is so diversified that it is only rarely fulfilled by a single economic agent. In most cases, various participants hold separate parts of such information and expertise. Therefore, in order to coordinate and efficiently operate a marketing channel, a cooperative relationship should be formed.

### Difficulty of information trade

The appropriate application of information can yield profits. One method of exploiting information is to sell it directly in a market; but, trading information is not always possible due to its specific characteristics. First, the owner of information is often the only one capable of thoroughly evaluating it. Buyers of information cannot determine its value *ex-ante*, and often cannot correctly judge information even after it is acquired. Sometimes, buyers need to collect equivalent information by themselves to judge the value of the provided market information. If buyers must bear the cost of collecting information, they need not buy information gathered by others. Conversely, when a buyer cannot evaluate the quality of the information for sale, the seller may not divulge all the information he knows but only a portion of it, or in worse cases, he may intentionally transmit false information.

How does one contract for the trade of information? Under a fixed price contract irrespective of the content, sellers would not collect precise information incurring high costs. If buyers produce and market new products based upon imprecise information, little profit is gained. As a result, the market demand for information would be small, which would in turn discourage sellers from collecting information. Sellers' attentiveness to their own reputations may resolve this difficulty caused by asymmetry of information.<sup>15)</sup> However, because not all products planned on the basis of faulty information find buyers, it may be difficult for manufacturers to establish and maintain reputations.<sup>16)</sup>

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15) See Akerlof (1970).

16) When sales face slumps, it is not always easy to recognize whether the cause is false information or an inappropriate plan or inadequate sales promotion.

Next, consider a contract under which a set portion of sales or profits from a newly developed product is promised in exchange for the traded information. Such a contract induces the buyer of information to understate his sales or profits. In order to suppress this type of opportunism, the buyer must monitor the performance of the seller. However, monitoring is not easy for a seller who does not have the know-how about planning and sales promotions.<sup>17)</sup> When monitoring costs are prohibitively great, the trade of information is suppressed.

Third, because information can be copied easily, the holder could earn much profit by selling the same information to several buyers. In those situations buyers plan their products based on the same information, and because the market is flooded with very similar products, they do not get much profit from the products if they are spared from suffering losses. Thus, the value of information depends also on the number of economic agents who plan and develop new products based on the same information. Therefore, when copied information is expected to circulate, the demand on information becomes small.

The trade of information is difficult because of the reasons just explained. Another method to convert information into profit is for holders to utilize it directly. Efficient methods are dependent on the properties of the information. In some cases, the holder would benefit from participating in the distribution process. Thus, many agents participate in various capacities in a marketing channel.

### III-2 Various Distributors

It may be that no economic agent holds all the information necessary to operate a marketing channel effectively. In such cases, the information gap between production and consumption should be bridged by the participation of multiple economic agents. The following subsection overviews the information- transferring function of various kind of distributors, such as retailers selling to consumers, wholesalers mediating between manufacturers and retailers, and so on.

#### Retailer

Consider the marketing of a consumption good. In the end, the primary purpose of the marketing system is to provide consumers some goods. This function is executed by retailers, and without them the distribution system does not work. To carry out their purpose, retailers fulfill various functions such as transferring information or promoting sales. First, declaring themselves as *sellers*, they inform consumers where to buy, which helps consumers to save their search costs. Sharing information about product quality with consumers who do not have sufficient knowledge is another of their important responsibilities. When there is a severe discrepancy in the amount of information sellers and buyers know of a product's quality, the market can not work well. This difficulty in trades can be overcome with by establishing a good *reputation*.<sup>18)</sup> Here reputation is defined as the buyers' expectation based on past trade experience that "the seller should not sell dishonestly a good of poor quality under a pretense of high quality." High reputation enables the seller to set high prices.<sup>19)</sup> If retailers take a dishonest attitude, they themselves are

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17) If the buyer had those know-how, they should have not sold the information but developed and sold a new product.

18) See Shapiro (1983).

blamed by consumers, and will lose their good reputation. For these reasons, retailers should not only gather information about the qualities of goods and share it with consumers, but also sell the goods with a guarantee of their own responsibility.

Why do agents with information regarding demand not sell the information to manufacturers, but instead choose to participate in a marketing channel as a retailer? Aside from the difficulties in trading information, there is a problem that when manufacturers get information from middlemen that they do not always provide suitable goods to consumers. In order to preserve their reputations, middlemen should examine the quality of goods traded. So, most of those who have reliable information avoid the difficulties mentioned above and choose to become retailers, buying goods from manufacturers.

Further, after gathering and comparing information about diversified goods retailers select an *assortment* of specific goods which are expected to suit the consumer's preference and behavior. When consumers buy some search goods, they wish to compare and select from among several substitutable goods. Also, when they buy convenience goods, they may like to buy related goods collectively. Assortments suiting such consumer behavior makes one-stop shopping possible and saves on purchasing costs.<sup>20)</sup> Then, declaring as sellers with an assortment of goods, they not only save consumers' search cost, but also transfer suitable information about the quality of goods. Thus, retailers advise manufacturers what commodities consumers as a whole demand, and notify consumers what commodities manufacturers as a whole produce.

### Wholesalers

Retailers' activities are based on their stores and are a somewhat local phenomenon. In fact their marketing areas typically cover small regions. On the other hand, manufacturers have a tendency to gather together in a specific district because of external conditions which aid in production.<sup>21)</sup> Thus, because manufacturers and retailers are generally separated geographically, it is rare for retailers to know what commodities manufacturers produce. This is the same for manufacturers: they do not have enough information about what kind of assortment retailers wish to construct. When this kind of information gap arises between manufacturers and consumers, wholesalers assume the responsibility to mediate between them.

Certainly, if sellers (manufacturers) and buyers (retailers) each conduct random searches, it costs them considerably. Wholesalers can save search costs by performing the task intensively and systematically. Wholesalers deal in goods from numerous manufacturers which are to meet the diversified demands of retailers. Further, when transactions are mediated by wholesalers who accumulate a comprehensive inventory of products, they can provide rapid delivery service and help retailers conjecture inventories.<sup>22)</sup> Also wholesalers categorize and collect ratings on the

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19) In order to establish and maintain a reputation, of course, sellers incur various costs. The cost is a kind of investment for them, which is recovered over a long-term through the high price corresponding to the level of the reputation. Thus, reputations are valuable assets for sellers, in the meaning that their preservation gives the holder positive cash flows. Therefore, the seller who establishes a reputation should avoid dishonest trades which may destroy such an irreplaceable asset.

20) Competitive conditions with other retailers at a district should affect the assortment they build.

21) See Williamson (1975).

22) See Hall (1948). Nevertheless, because a construction of a transportation center is enough to secure benefits from savings of transactions and centralized inventory, this principle alone cannot explain the mediation of wholesalers.

goods provided by manufacturers. This process should have economies of scale. After the ranking, they guarantee the rated goods on their reputation to resell to retailers. Thus transferring quality information from manufacturer to retailers, wholesalers can summarize and coordinate information between them.

When manufacturers preserve a good reputation and retailers are well informed about what commodities manufacturers make, the information gaps between production and consumption narrow. In those cases, wholesalers as middlemen are not necessarily needed. Also, when a sole producer provides comprehensive goods by which retailers can construct their specific assortments, wholesalers may be removed from distribution channels because benefits from the principle of minimum number of transactions are dissipated. Moreover, consider a situation when consumers buy search goods such as apparel. As they visit several shops to compare several commodities and choose their preferences, recommendations by retailers significantly affect the consumers' choice. Those recommendations play important roles in sales promotion. Therefore, manufacturers wish to establish and preserve cooperative relationships with retailers so that their products are approved by retailers and, in turn, recommended for consumers. For these reasons, wholesalers are sometimes excluded from these transactions.

### **III-3 Summary**

As is seen above, various economic agents intervene in distribution processes with diversified information, knowledge, and know-how to bridge information gaps between consumption and production. In the distribution of consumption goods, retailers who sell to consumers, the final buyers, are indispensable. When there are large information gaps between manufacturers and retailers, wholesalers mediate for them.

Beside their mediating function, wholesalers take various roles utilizing their own information. They form original expectations based on information about the best selling goods, demand trends, and prospects of future market conditions. Arbitrages of regional price discrepancies and speculations about price differences in the future can be understood as activities which attempt to convert this information into profit. No details are given here, but note that existences and functions of cash-and-carry wholesalers are recognized from this aspect.

## **IV Multi-step Wholesale Channels for Textiles**

Some of the various aspects of marketing channels can be understood as mechanisms to convert information into profit or devices to share the risks which accompany such activities. From this viewpoint, this section considers the multi-step wholesale channels which characterize the textile industry and its *chin-ori* subcontracting.

### **IV-1 Basic Standpoint**

In textile fabrication, numerous manufacturers gather in specific districts, and related manufacturing units are controlled and operated by independent economic agents who divide tasks mutually. Between each phase of the process, yarn mills, *oya-bata* parent weaving houses, and wholesalers (such as trading houses) mediate and coordinate the whole manufacturing system.



Consumer preferences for textile goods are not necessarily stable, so that endeavors in planning, designing, and promoting sales are very important. In these circumstances, agents who are entrusted to link preferences to production play an important role, which gives them opportunities to profit. In manufacturing fabrics, wholesalers gather information for planning and designing new products. Wholesalers acquire information about best-selling products, production trends, and market conditions from their own transactions. In order to profit from such information, wholesalers themselves plan, design, and market their own products. Of course, the processes of collecting information and planning are not quite enough. Because of difficulties in trading information, wholesalers who plan and design new products have to organize manufacturing processes by themselves. Nevertheless, wholesalers who lack the technological knowledge or know-how to produce efficiently should utilize their information on production trends, but assign the manufacturing processes to subcontractors.

Then, why don't subcontractors gather information independently? Under the condition where numerous subcontractors divide successive manufacturing processes, it is not wise for them to produce products based on their own estimates of future demand and supply. Because there are gaps in each subcontractor's private information, they should consign specific agents to gather information to save cost. In order to coordinate various processes, and avoid increases in inventory due to lags between processes, it is rational to employ specific agents to gather information. Therefore, wholesalers, such as trading houses, gather information and coordinate the whole system, consigning subcontractors to produce only what they plan and design.

Note that information gathered about consumption trends is not always accurate, so that some risks in marketing manufactured products still remain. Moreover, in *san-chi* production districts, often the same information is realized by many at the same time, causing the price to drop. Also, the sales of products depend on how hard distributors such as wholesalers endeavor to promote sales.

In this circumstances, what type of contract best gives the distributors the incentive to plan properly and market positively, and to share risks with manufacturers? The most important point to recognize is that even the amount of sales, as well as endeavors for sales promotions, are not necessarily observable by manufacturers. Wholesalers are apt to understate the amount of sales or profits, when profits are to be shared with manufacturers. In order to avoid this type of opportunism, payments to manufacturers should be linked to the amount of production which is observable by both of parties of contract.<sup>23)</sup> The *chin-ori* subcontracting is arranged so that manufacturers are paid a constant rate of returns (depending on the amount manufactured) and so that the wholesalers who organize planning and sales promotions are given incentives. Under this compensation structure, no risks are taken by small manufacturers who are risk averse, but by wholesalers who have information about market trends. Wholesalers who achieve success get deserved profits, while those who fail, lose. Efforts at gathering information, planning and designing suitable products, and making efficient sales promotions are rewarded by the market.

Under *chin-ori* subcontracting, the profits of manufacturers do not depend on the amount of sales. Therefore they need not manage production based on information they gathered on their

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23) When wholesalers do not have information on manufacturing technologies, manufacturers may overstate their cost to acquire more profits. In textile industries where numerous small manufacturers exist, the opportunistic tendencies of manufacturers do not matter because of the severe competition.

own. Moreover, they need not keep inventories to adjust to fluctuations in market demand. Responsibilities for determining production levels estimating future market trends plus all of the costs caused by the miscalculations of those estimations are born by distributors including wholesalers.

#### **IV-2 Division of Processes Among Firms**

If division of processes are presumed, it makes sense that manufacturers be geographically concentrated. Ideally all manufacturers would be organized by one agent to save on transportation costs and enable smooth coordination. Then, why are processes ever segmented? Distributors such as wholesalers help finance small manufacturers directly or indirectly. For example, they often provide their looms. Thus, wholesalers can afford to have facilities to produce by themselves at least for a part of their requirements, if it pays. Therefore wholesalers must reap some obvious benefit in consigning manufacturing processes to independent subcontractors. Why aren't wholesalers engaged in manufacturing by themselves? This subsection investigates this issue.

We suspect that the technical conditions that enable independent manufacturers to operate segmented production processes within the textile industry include the following. While the upper-stream processes in the textile industry tend to be quite standardized, numerous kind of goods are nevertheless produced in small lots.<sup>24)</sup> Small lot sizes and the dispensability of higher technologies allow manufacturers with comparatively small capital to conduct manufacturing processes. This enable numerous tiny manufacturers to enter and survive in the industry. Moreover, although diverse products are produced, most production facilities (processes) are for general purposes.

There are several advantages to organizing successive related processes in one company. The first is the easy coordination of processes, -- although this benefit alone does not imply that the organization of all processes in one company is necessarily the best option. In the production of fabrics, time lags between processes do not impose large costs. Processes are coordinated based on the instruction documents provided by wholesalers. The second advantage to this organization is in having the capability to monitor in long-term, which helps to guard against the transfer of selective and false information.<sup>25)</sup> However, it is not to say that this merit is indispensable to solving the problems involved with information transfer. Wholesalers can gain information about market trends only by engaging in planning and bearing risks. The third possible merit is associated with having specialized equipment relating to these manufacturing technologies. However, within this industry one does not profit much from owning certain equipment, because fabricating machines can be used for a wide range of purposes. Considering the fact that many companies both within the United States and Japan operate integrated processes, segmentation may not be a more efficient process. Although, profits earned under integration have not shown to be much greater than those earned under segmentation.

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24) This tendency is more notable in woolen fabrics than in cotton and rayon fabrics or synthetic fiber fabrics.

25) See Williamson (1986).

### **Theory of contracts**

Contract theory states that when investments in tangible assets are important intra-organizational integration is desirable, while when investments in human capital are most important, segmentation is desirable.<sup>26)</sup> Because investments in human capital are hard to describe in a contract document, and moreover, because those contracts are difficult to enforce, those who invest in human capital should bear the cost, irrespective of who invests in tangible assets. While joint profits increase due to human capital investments, the ex-post distribution of acquired profit depends on the ownership distribution of tangible assets. That is, participants without tangible assets (right to claim residual controls) have low threat points, so are at a disadvantage in sharing joint profits. Therefore, investments in human capital are likely to be too little. In order to stimulate investment in human capital, investors usually have tangible assets to complement human capital. This results in the formation of a quasi-integrated, intermediate organization. However, when investments in human capital are extremely important, or when a certain participant should be joined to exploit profits from investing in tangible assets, an internal organization under which the agent possesses all assets is chosen. But when assets are highly complementary, such that without one facility the whole value would deteriorate, an internal organization under which one agent owns all the tangible assets is most often formed.

In fabric manufacturing it is not so important to invest in tangible assets. For example, dyeing and finishing processes are necessary for intermediate goods, but no certain skilled person is indispensable at that stage because the process is not so detailed. Moreover, although the processes are mutually complementary, their generality prevent them from being organized internally.

### **Separation between planning and production**

Next, we investigate the separation between wholesalers, the agents who plan and design, and manufacturers. Generally, extensions of organizations enable employees to be more easily dispersed, and make possible flexible administration. However, this merit is accompanied by the following demerit. When different agents operate separately, their contributions to profit are relatively clear. When, on the other hand, there are several teams of workers who engage in different operations and who keep mutual communications actively in one organization, it is difficult to identify each one's contribution to the profit. Thus, the connection between their performance and compensation becomes ambiguous, which discourages employees from exerting efforts. Moreover, there may emerge a team who tries to change distribution rules, trying to manipulate its share of the profit.<sup>27)</sup> If rigid rules are employed to discourage such influences, one has to worry about bureaucratic domination that might result in an inflexible organization. Another disadvantage is in the negative externalities which may result when product planning and manufacturing are integrated in one organization. When respective functions are operated by different agents, moral hazard problems can be avoided because the agents responsible for the operation are the very same who enjoy the benefits from the operation.

Other factor which motivates planning wholesalers to separate themselves from manufac-

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26) See Grossman and Hart (1986) or Hart and Moore (1990).

27) See Milgrom and Roberts (1988).

turing subcontractors involves the wage difference between large and small firms, a peculiar aspect of Japanese industries. In fact, as subcontracting weavers are generally small, their commissions are low.<sup>28)</sup> Weaving houses are typically household firms and most weavers have other some side-job, such as farming. At night or at seasons when they are free from farm works they employ themselves in fabricating works with rented looms. Under these conditions, it is not wise for wholesalers to engage in their own production which would involve hiring full-time employees at higher wages.

#### IV-3 Trade Customs: Ambiguous Contracts

In *san-chi* districts, *oya-bata* parent weaving houses and yarn mills organize and coordinate production systems. The orders of wholesale manufacturers and yarn mills are not always accompanied by detailed contract documents.<sup>29)</sup> Why not? Needless to say, the contracts contain fewer descriptions, then firms have a wider variety from which to choose. As demands for textile products are very uncertain, the amount of commissioned subcontracting severely fluctuates. This phenomenon is exacerbated by the similarities in expectations among wholesalers. In the production of textile goods, adaptation to fluctuating market conditions is very important, and lack of specification in contracts can be understood as a tactic which gives wholesalers some leeway in this regard.

Another alternative to this problem would be the creation of a conditional contract which could accommodate for all the complicated contingencies associated with such an unpredictable market. Bounded rationality prevents them from making such a contract. Although contracts can specify certain tasks to be carried out under specific circumstances, no rigid contract can adapt the production (sales) system to the fluctuations of an uncertain and complicated environment.

Next, consider an *incomplete* contract which describes beforehand only a range of tasks to be performed. Under such contracts the actual task to be completed is given after they know the market demands.<sup>30)</sup> Although under incomplete contracts they may behave opportunistically, a long-term relationship may help to prevent such behavior as described in *theories of repeated games*.<sup>31)</sup> When one trades only once, conflicting interests are emphasized. However, when contracts can be renewed and there are opportunities could benefit both of them, rather than bring the contract to an end in the interest of opportunism one should agree to a cooperative venture to retain long-term profit.

In long-term relationships, various factors, such as reputation, can be used to suppress opportunistic behavior for the sake of long-term benefits. Moreover, there are various incentives for such relationships, because one's rewards or profits for each period need not correspond to his own performance and because monitoring becomes more feasible. At the same time, wholesalers need not set a fixed compensation rate for all of the subcontractors they consign. They can set

28) As described in the subsection 2-2, at Bansyu san-chi district, the total shipment from more than two thousands subcontractors amount to only 100 billion yen, which implies about 40 million yen per subcontractor. As the mean number of workers is four, the earnings are only 3 million yen per head when the commission rate is 30 percent.

29) This practice involving undetailed documentation is not unique to textile distributions, but one seen in various industries in Japan.

30) See Williamson (1975) or Simon (1951).

31) See Kreps (1990, chap. 14) or Fudenberg and Tirole (1991, chap.3-5).

a fixed rate depending on the subcontractor's past performance, or reputation. In this situation subcontractors are likely to avoid opportunistic behavior which might damage their reputations. The same holds true for wholesalers. Opportunistic behavior on their part, such as refusal of consigned products, damage their reputations among all subcontractors, not only the subcontractor betrayed. Thus wholesalers also avoid opportunistic behavior. Mutual understandings fostered in long-term relationships strengthen their reliance on one another, so that contracts need not be so detailed. While the lack of specification makes contracts ambiguous for outsiders, it also saves on transaction costs.

An advantage in operating a production in one organization which does not have detailed assignments *a-priori*, is that it can promptly adapt to the changing environment. In manufacturing fabrics, this merit may be retained although tasks are segmented among subcontractors. By working close within a specific district, manufacturers and subcontractors find it easy to hold a reputation in common, which helps to dissuade opportunistic behavior for both parties involved. As those in the same profession living closely within a small district *san-chi*, it is easy to imagine that they hold much in common. Additionally, since their proximity allows for rapid communications the production system can be adjusted easily without any established mediating organizations.

In contrast to former times when there were *tebari* weavers who gathered information by themselves, took risks in buying threads, and sold their final products, now *chin-ori* subcontracting is typical. We saw how *chin-ori* have been integrated into the multi-step wholesaling system and how adjustments to and organization of the manufacturing processes is done in *san-chi* districts. In this situation the phenomenon can be understood as economically rational behavior. Recently, as consumers' preferences have become more diversified, and as planning new products and promoting sales have become more important, the role of gathering information and organizing the whole system is being shifted from district trading houses to larger yarn mill or general trading companies. However, we expect that this shift in responsibilities will not change the role of the body who gathers information in the multi-step wholesale system, so that the measured length of the wholesale system may not be decreasing.

## V Apparel Distribution System and Returns Policy

In this section, an overview of the transitions in the apparel distribution, especially the rise and decline of wholesalers' tendency to relocate near retailers, are provided from the viewpoint of effective information transfer in marketing channels. Also, we investigate the function of returns policies from a standpoint of risk sharing and information transfer.

### V-1 Wholesalers Located within Consumption Area

The focus of apparel production is on the wholesale manufacturer (apparel maker). They gather market demand information which enables them to plan and design new products and to organize the manufacturing system. Apparel products are so diverse that the lot size is generally small: it is not rare that a fashionable women's apparel product is produced with a lot consisting of only one hundred pieces. There are not strong economies of scale and numerous wholesale

manufacturers engage in production in this market. Wholesale manufacturers sometimes have their own facilities to produce a portion of the final product. In most cases, however, they consign manufacturing to subcontractors. Most of the products manufactured are sent directly to retailers. However, some of them are sold to wholesalers located near the consumption area (hereafter denoted as "consumption-area wholesalers"). Recently the distribution channel described above has diminished in importance, although it once was the apparel industry's main route of distribution. Why did this type of wholesaler exist? And why are they now disappearing? This subsection investigates this problem.

The main justification for the existence of consumption-area wholesalers rests on the information to which they have access. They have lots of information about the consumers in their area. In order to convert this information into profit, they mediate between wholesale manufacturers and retailers. Although they can sell their information to wholesale manufacturers, the properties of information described above make the sale difficult. An alternative is to intervene in the distribution process themselves. The multi-step wholesale system, characterized by the wholesale manufacturer -- consumption-area manufacturer -- retailer pattern is the result of this mediation. This justification may need to be elaborated.

First, why don't wholesale manufacturers trade directly with retailers in order to learn more information about consumers' behavior? For wholesale manufacturers, who plan and design new products, more information should be desirable. Although they could acquire more information in transacting with retailers, they incur costs in doing so. For some apparel goods, consumer preferences differ from person to person and region to region, but the average demand trends are stable. In such conditions, the benefits from the information gathered from retailers are outweighed by its costs; so, for wholesale manufacturers, it is more advantageous to plan new products based on the information transferred through consumption-area wholesalers. Thus, not all information is transferred strictly through marketing channels, as such routes may come with higher costs.

Next, let's examine the retailers' responses. Since they face consumers directly, retailers can acquire much information about their customers. Those retailers can trade directly with wholesale manufacturers, by-passing the consumption-area wholesalers, as they select their stock based on their own information. Why, don't they do so? Consumers' behavior may show differences depending somewhat on their location, but the differences are not generally so diverse. Therefore, there should exist economies of scale in gathering information about, and analyzing consumer behavior. These economies of scale and the specialized knowledge needed for analysis is the basis for the mediation. In short, consumption-area wholesalers summarize and report the information to wholesale manufacturers.

Most retailers may be able to save cost by delegating such analyzing activities to specialists rather than doing it themselves. However, as explained repeatedly, trading summarized information is a very difficult task because of the specific nature of information. To avoid such problems, consumption-area wholesalers engage in distributional trades. The risk taking activity, accompanied with buying-in guarantee the reliability of information traded. Thus consumption-area wholesalers transfer summarized product information to retailers, bridging the information gap between manufacturers and retailers. This mediation, of course, makes the distribution channel longer.<sup>32)</sup>

Note that consumption-area wholesalers have an advantage over retailers in assortments. For practical reasons, retailers sometimes delegate assortment-selection responsibilities to consumption-area wholesalers. However, wholesalers have important information, but they are not perfect. So, even if they base the purchases of apparel products on their rich information, there remain significant risks. Under purchasing contracts, these risks are born by retailers. Since they are without risks, consumption-area wholesalers might buy inappropriate amounts of products, which may lead to problems in the trading system. The policy under which wholesalers liberally accept returns of unsold goods can be understood as an instrument to alleviate this problem. Under such a policy, the consumption-area wholesalers themselves bear the risks from unsold goods, that is, inappropriate assortments are penalized. Therefore, they attempt to make appropriate assortments based on the market trend information they've gathered and analyzed. Needless to say, this mechanism improves the reliability of the assortments and the information they supply.

## **V-2 A Recent History of the Distribution System**

Beginning in the early 1970's, after the high growth period, consumers' preferences became more diversified, so that it became more important to gather and analyze information about consumer trends in planning new products. This, coupled with the innovations in information processing, encouraged the distribution system to evolve so that the distance between wholesale manufacturers and consumers (retailers) became shorter. This subsection investigates the transition of apparel marketing channels from three aspects: the encroachment of apparel makers into retailing markets, the establishment of brands (reputation), and the development of general merchandizing stores (GMSs).

### **Advances of apparel makers into the retail market**

Consumers' preferences for apparel goods, especially women's fashionable apparel products, are so diverse that the number of products is numerous. And since fashion trends change so rapidly, apparel items quickly and easily lose popularity with consumers. To make suitable planning for such goods it is necessary to rapidly gather information about consumer trends. On the other hand, it is also established that not all consumers have determined preferences, and that sales are affected considerably by information offered through marketing. In this sense diversity in consumers' preference is only an epiphenomenon. Under these circumstances, wholesale manufacturers' direct trades with consumers become more important as a mean of gathering information and affecting fashions. For this reason, some wholesale manufacturers advanced into the retail market, excluding consumption-area wholesalers from the market and making the distribution channel shorter.

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- 32) Other than consumption-area wholesalers (who plan and design) and wholesale manufacturers (who organize manufacturing,) sometimes the distribution of apparel products are mediated by wholesalers located at entrepôts, whose main role is to adjust demand and supply. When close substitutes exist, it is hard for individual manufacturers to attain the adjustment for the whole system including those substitutes. Under such circumstances, a coordinator, who adjusts the whole system, is necessary to run the distribution system smoothly. The wholesalers located at entrepôts take on this role. They adjust the whole demand and supply accumulating inventories. As they deal with diversified products, they are very competent to pool risks. Thus they contribute to smooth operation of the distribution system, while taking large risks.

Among the various apparel goods distribution channels, a typical one for men and women's outer wear is sales by a national brand apparel maker through department stores. Also, fast growing apparel makers such as WORLD Co. Ltd. or ITOKIN Co. make available their women's apparel through so called *only-shops*, which is another typical distribution channel. In the latter case the apparel makers advance directly into retailing, while in the former case the channel is lengthened to include department stores. However, there is no fundamental difference between these two cases. Entering into contracts of commission sales with department stores, some apparel makers take responsibility for sales, even dispatching their own salesclerks. Thus, to put it bluntly, department stores only lease their shelf space, so that most tasks in the retail stage, from assortments to sales promotions, are executed under the responsibility of apparel makers. Apparel makers achieved their great success by accumulating various information about consumer trends from their trades with department stores, and by putting such information into active practice.

### **Building the brand (reputation)**

At one time consumers obtained a great deal of product information from retailers. One of the roles of consumption-area wholesalers is to supply retailers with such information and through this, to accomplish sales promotions. When these functions lose their weight, the reason for their existence may diminish, or the channel may become shorter. Consider the case of the distribution of underwear. Previously, the major route of distribution of knitted underwear was through wholesalers. However, when GUNZE Ltd. captured a significant portion of the market shares, the channel experienced great change. Until then a considerable part of underwear supplied through the channel was of inferior quality. In such a market consumers began to respect the quality of GUNZE products partly because of GUNZE's providing superior goods and partly because they established their brand name through advertisements. Of course, this marketing strategy was successful because of various avenues of reaching the mass-media which came with the development of information technology, including the spread of TV sets.<sup>33)</sup> Once a brand has established a good reputation, as in this example, many retailers come to know the apparel maker; their affiliation fills up the information gap between manufacturer and retailer, and leaves little room for wholesalers. In fact, Gunze has excluded wholesaling mediators who previously worked to establish the dealers they represented within the channel.<sup>34)</sup>

### **Development of GMSs**

The development of GMSs is a factor contributing to change in the marketing channel for underwear. However, the effects of GMSs are not confined to the distribution of underwear. When retailers become large and come to trade with numerous consumers, they can exploit the economies of scale in gathering information and through specialization. For this reason, GMSs need not utilize consumption-area wholesalers, and can make assortments based on their own informa-

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33) One of the factors which lead to the decline of consumption-area wholesalers is the dilution of heterogeneity in consumers' behavior through the development of mass-media; their function as an information provider and sales promotor has thus lost importance.

34) Ryutsu Mondai Kenkyu Kyokai (1981, P.94).



tion. In fact, there has been a definite increase in the number of retailers who trade directly with wholesale manufacturers or through wholesalers located at entre-pôts. Thus, fewer and fewer retailers are still trading through consumption-area wholesalers.

### **V-3 Returns Policy**

In the distribution of apparel products the practice of returning unsold items still remains. Because this practice has become a sort of custom in the apparel industry, unsold as well as defective goods are accepted by wholesalers. Why do they accept returns? This sub-section analyzes this problem. If there were no uncertainty in demand, there should have been no returns because retailers would order the exact amount they sell. Even if there is uncertainty in demand, so long as the commodities do not lose their value as time goes by, returns benefit retailers only in the saving of inventory costs. However, for most apparel goods, especially for fashionable apparel, demands are uncertain and perishable. This kind of good is likely to have insufficient sales at a given price, which causes unsold goods. Also when retailers discount prices to increase the amount of sales, they have to bear losses. Who should endure such sales risks (losses), -- wholesalers or retailers?

When returns policy is introduced in trades between wholesalers and retailers, it is better for retailers to ask wholesalers to accept the unsold goods at the same price they were bought than to sell goods at a price below the buy-in cost. In this situation, contrary to the purchasing contracts, retailers would not bear any loss accompanying the unsold goods, and all sales risks are endured by wholesalers. Considering the risk-sharing problem, one should notice that distributors can pool sales risks by dealing with diverse goods. Wholesalers dealing with diverse goods can also pool risks effectively. Moreover, because the variety of products is linked with the scale of the distributor, larger distributors have more ability to pool risks. For these reasons, wholesalers who trade with various retailers selling in different markets can be expected to have a high ability to pool risks, as they are generally larger than retailers and have wider assortments. Furthermore, wholesalers have better access than individual retailers to information about consumer trends because they accumulate and analyze information on all of their retailers' sales. This also provided a basis for risk-taking behavior by wholesalers.

### **Sales promotion**

In the sales promotions of search goods like apparel, the displayed goods in the shop window have an important role.<sup>35)</sup> Under a purchasing contract in which they have to bear all risks, retailers order less than would optimally promote sales, as they are afraid of unsold goods. A method of drawing out more orders from retailers is to mitigate their risks on sales. By introducing a policy under which wholesalers accept unsold goods, a transfer of sales risk can be attained. If retailers are risk-free then an optimal level of displayed goods for the wholesaler or for the whole distribution system can be achieved.

On the other hand, a liberal returns policy may induce risk-free retailers to order more than necessary, as a means of avoiding stock-outs. When all of these orders are not coupled with

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35) In Japan sales by catalogues including mail-order sale have only a small share of the market, although it has grown fast recently.

a sale, enormous amounts of unsold goods are returned. Those unsold goods mean a waste of resources. A method to avoid this problem is for the manufacturer to consign a certain amount of goods to be sold to retailers. By this method they can determine the optimal amount of displayed goods for the channel. However, returns cannot be avoided completely. Where do those returned goods go? There are some cases in which they are discarded to preserve the image of the manufacturers' brand. In most cases, however, they are sent to other retailers through wholesalers. These transactions obviously make the distribution channel longer.

An alternative method which encourages large orders from retailers is setting a high retail margin. Resale price maintenance and a liberal returns policy achieve similar results.<sup>36)</sup> Nevertheless, in Japan, resale price maintenance is prohibited per se, while severe competition prevents retailers, from setting high margins in retail markets. Also, even if resale price maintenance is an option, retailers should bear sales risks under purchasing contracts, so that a considerable risk premium would be paid to retailers, who themselves are too small to accept risks.<sup>37)</sup>

A disadvantage of a liberal returns policy is that it discourages retailers from actively promoting sales. Because retailers are free from sales risks under the system, it is understandable that the level of effort toward sales promotion is less than it would be under a buy-in contract. Therefore, to ensure that sale promotion efforts are at an optimal level, countermeasures are taken, of which the rebate system and dispatched sales clerks are examples. For fashionable apparel goods, department store displays are so advantageous that department stores have the power to demand returns privileges. Given such conditions, it is a matter of course that sales promotions by department stores decline and that the ratios of returns increase. Therefore, wholesale manufacturers see to sales promotion by dispatching their own sales clerks. The sales clerks' presence discourages information-gathering efforts by department stores, and diminishes their ability to plan and design new products. With this strategic move, wholesalers are able to accumulate information about consumption trends and have enhanced their ability to plan.<sup>38)</sup>

### **Information transfers through marketing channels**

Another function of the return policy is to help smooth information transfers throughout marketing channels. The performance of a channel depends on the amount and the value of the information obtained by its respective members. Presumably only the wholesaler has market trend information, and the retailers are in the dark concerning this matter. In this situation, retailers who cannot estimate demand have no basis on which to adjust their order schedule. They can only order a constant amount regardless of the market's fluctuations. The channel cannot adapt sales promotions to the current situation, and the information held by wholesalers is not used.

Thus, an asymmetry in demand information between wholesalers and retailers exists, information transfers increase the efficiency of the channel. But, how is the information held by wholesalers transferred to retailers? In purchasing contracts under which they do not bear sales risks, wholesalers may transfer intentionally distorted market information in an attempt to draw out more orders from retailers. Expecting this kind of behavior from wholesalers, retailers do not

36) For this point, see Marvel and Reagan (1986), Flath and Nariu (1989), and Nariu(1996).

37) In Japan retailers are generally small and cannot bear many risks, which explain why the returns policy prevails in Japan.

38) See Ejiri (1979).

always believe the shared information. Thus the information may not be transferred.<sup>39)</sup> On the other hand, under a liberal returns policy in which wholesalers accept unsold goods, excessive orders based upon an exaggerated anticipation of demand only leave wholesalers with many returns, and waste production costs. For this reason, wholesalers reveal correct information, on which retailers rely. But, when only retailers possess information, the use of purchasing contracts which names retailers responsible for bearing sales risks is the best way to assure smooth operation of the distribution channel.

The observations and hypotheses can explain the evolution of apparel distribution as follows: Once, wholesalers, including wholesale manufacturers, gathered information about consumption trends, which enabled them to determine what to make and how to sell. At that time, consumption-area wholesalers possessed relatively rich information, and accepted returns in order to transfer that information. As for fashionable and perishable apparels, most of the products were new designs, so that information regarding apparel demand was obtained by the wholesale manufacturers who planned and designed. To promote sales of such goods, displays in shop fronts were indispensable. Therefore, wholesalers would transfer to retailers correct information about market demand and draw out orders from them to secure an optimal amount of displayed goods. Liberal returns policies enabled such information transfers as well as mitigated the sales risks of retailers. Recent growth of large scale GMSs and the advantages in information technology allowed some retailers access to more information than wholesalers. Under these circumstances, retailers started to plan and design new products, and consign production to manufacturers directly, while they bought the whole goods produced and bore all sales risks. The exclusion of wholesalers and the shortening of the channel were the direct results of retailer's opportunism. Moreover, in order to dispose of unsold goods under purchasing contracts a new type of retailer became necessary. A typical example of these new retailers is the outlet which buys and resells unsold goods, and which was recently developed by department stores.

#### **V-4 Summary**

In apparel distribution, consumption-area wholesalers once mediated for wholesale manufacturers and retailers, bridging the information gap between them. However, because of the increasing importance in following consumption trends and the increasing diversity among consumers, consumption-area wholesalers became excluded, thus shortening distribution channels. At the same time, the establishment of wholesale manufacturers' brands, the development of large scale GMSs, and the advantages in information technology also helped to fill the information gap between wholesale manufacturers and retailers. Together, all of these factors results in making channels shorter. In spite of all this, it remains true that those who plan and design new products gather market information and bear sales risks. Therefore, when a wholesale manufacturer plays the main role in a distribution channel, he bears risks having a liberal returns policy. On the other hand, when a large scale retailer plans a private brand commodity, a purchasing contract is preferred.

Thus various factors help to determine whether a liberal returns policy or purchasing con-

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39) Mutual trust based upon long-term relationships may enable transfers of market information. However, demand estimations for fashionable apparel are so unreliable that it is not easy for them to maintain such reputations.

tract is adopted. All risks are born by wholesalers under liberal returns policy, and by retailers under purchasing contracts. Thus, first, when retailers (wholesalers) are risk neutral, a purchasing contract (liberal returns policy) leads to optimal risk-sharing. Second, when retailers (wholesalers) play important roles in sales promotions, desired incentives are given by purchasing contracts (liberal returns policy). Third, when wholesalers have private information about consumption trends and have entered into a purchasing contract, they are inclined to transfer distorted information to get more orders from retailers. On the other hand, as there are no such incentives under a liberal returns policy, retailers get a smoother transfer of information from wholesalers.<sup>40)</sup> On the contrary, when retailers have more information about the market, purchasing contracts are adopted to achieve a more efficient use of such information. Fourth, under return policies retailers tend to place exaggerated orders. Therefore, when manufacturing costs are substantial the best way to avoid losses resulting from unsold goods, is to select a purchasing contract.

## VI Conclusion

Although a wide range of information is needed to smoothly sell well-designed products to consumers through distribution channels, it is rare that any one agent has all the necessary information. Moreover, because of its nature, such information is hard to trade within the market. Therefore, for a marketing channel to operate smoothly various agents with diverse information should participate in the distribution processes. It has been observed that the participation of many agents results in long and complicated marketing channels. Fabrics marketing channels are organized by wholesalers (such as trading houses), who gather information about market trends, plan and design new products based upon this information, and sell manufactured goods. Moreover, to clarify their own responsibilities wholesalers hire *chin-ori* subcontractors to perform certain processes, and accept the risks associated with manufacturing. In this situation, contracts with the *chin-ori* are non-specific so that both parties can adjust to the fluctuating market environment. Products flow through manufacturing processes, with wholesalers mediate between each one, which results in a multi-step flow of ownership. In the field of apparel products also, wholesale manufacturers gather information about consumption trends and plan and design. Therefore, since they are the ones in the channel who collect market information they should be the one to bear the majority of the sales risks. So that retailers will have confidence in their predictions of consumers demands, wholesalers adopt liberal returns policies. Previously, wholesale manufacturers and retailers traded indirectly through consumption-area wholesalers. However, wholesale manufacturers' establishment of reputation and the development of GMSs have filled the information gap between manufacturers and retailers; this, in return, has led to the demise of consumption-area manufacturers and has shortened distribution channels for apparel products.

Multi-step wholesale channels in textile distribution does not imply inefficiency. Further, the existence of ambiguous contracts in fabric weaving and a return policy in apparel goods should not be regarded as obsolete trade customs. There are, at least, some rational reasons for

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40) See Nariu (1994, chap.6).

their inclusion. Besides, distribution systems are not permanent, but fluid. They change according to the social and economic environment, including factors such as the widespread use of automobiles or the development of information technology.

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